What Lessons Can We Learn From Enron's Collapse? A Case Study

Abdel M. Agami
Old Dominion University

The purpose of this case is to encourage students to think about the abuses of financial reporting rules by Enron and other companies in recent years. It provides students with an opportunity to critically examine the business environment that prevailed in the 1990s, the causes of the abuses of financial reporting rules, and the lessons to be learned from them. The case can be used in a financial reporting course (intermediate accounting or seminar in financial reporting), a finance course, or a business ethics course. A suggested number of questions and recommended approaches for discussing them are included in the teaching note along with selected bibliography. Some of the questions are directly related to the case, and others may require further reading and research.

In remarks delivered at the New York University Center for Law and Business, Arthur Levitt, former chairman of the Securities and Exchange Commission, stated:

> "Well today, I'd like to talk to you about another widespread, but too little-challenged custom: earning management. This process has evolved over the years into what can best be characterized as a game among participants. A game that, if not addressed soon, will have adverse consequences for America's financial reporting system. A game that runs counter to the very principles behind our market's strength and success."
>
> "Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be over-riding common sense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation" [Levitt, 1998].

In spite of the warnings by Mr. Levitt and others, the number of companies that manipulated financial reporting rules to show higher earnings in recent years has increased. When manipulation of financial reporting rules by those companies was discovered, the price of their stock collapsed; the decrease in the price of the stock of those companies has caused significant losses to investors and employees. Enron's stock price went down from $91 at the end of the third quarter 2000 to $0.25 in March 2002. WorldCom stock price went down from $64 in June 1999 to $0.06 on July 1, 2002. The abuse of financial reporting rules has also caused the loss of investors' confidence in the numbers reported by corporations in recent years, and is the reason that the stock market has been depressed for more than two years (2000, 2001, and more than half of 2002 so far).

ENRON SUCCESS IN THE 1990s

Enron was formed in July 1985 as a result of the merger of Houston Natural Gas and InterNorth of Omaha, Nebraska. In its early years the company provided products and services related to natural gas and electricity. Its operations included the transportation of natural gas through pipelines to markets throughout the United States; the generation and transmission of electricity to markets in the Northwest; the marketing of natural gas and electricity; and the development, construction, and operation of power plants, pipelines, and other energy-related assets worldwide. During the company's 15-year history, it had expanded its operations tremendously. The success of Enron in the 1990s is due, to a large part, to the efforts by Kenneth L. Lay. Mr. Lay received a Ph.D. in economics from the University of Missouri. He served as an aide to federal government regulators for the natural gas industry. Mr. Lay became chief executive of the Houston Natural Gas Corporation in 1984. He engineered its merger with InterNorth, and then became chief executive of the combined company which was later named Enron. At that time, gas prices were regulated. As oil prices decreased in the mid-1980s, Mr. Lay went to Washington, DC to lobby for deregulation of gas prices, which he succeeded in accomplishing. As a result of deregulation, gas prices started to fluctuate dramatically in the late 1980s. Lay had a vision of how Enron could help customers by shielding them from gas price fluctuation risk. While other gas companies focused on accumulating hard assets like pipelines, turbines, and gas fields, Enron developed hedging contracts for gas which allowed customers to lock up the long-term gas prices they craved [Schwartz & Appel, 2001].

The idea of managing the risk of price fluctuation in gas was very successful, and brought a lot of revenues to Enron. So Enron expanded these activities to other commodities such as electricity, wood pulp, and steel. Enron also expanded in the area of developing the bandwidth intermediation business to help customers manage unexpected fluctuation in the price, supply, and demand of bandwidth [Lee, 2001]. Enron's services included delivery of high-bandwidth media-rich content such as video streaming, high capacity data support and video conferencing. Enron invested in companies with related technologies and with potential for capital appreciation. The investments in these companies were accounted for on a fair value basis. Appreciations (decreases) in the market value of these investments are included in income statements. As the value of the stock of these companies began to decline in the late 1990s and early 2000s, Enron started to manage the impact of market price movements on these trading investments. The fair value as of December 31, 2000 of instruments related to price management activities held by Enron during the year as assets were: $10,270 million in natural gas, $1,549 million in crude oil and liquids, $7,335 million in electricity, $1,509 million in other commodities, and $795 million in equity investments, for a total of $21,458 million or 32% of the total assets reported in 2000. The fair value as of December 31, 2000 of instruments held as liabilities were: $9,342 in natural gas, $3,574 in crude oil and liquids, $5,396 million in electricity, $1,311 in other commodities, and $295 million in equity investments, for a total of $19,918 million or 36% of the total liabilities reported in 2000. Enron attributed its income before interest, taxes and certain unallocated expenses arising from price risk management activities for 2000 as $1,899 million, or about 77% of the total income before interest, taxes, and certain unallocated expenses [SEC, Footnote 3 of 2000 10-K]. In his Letter to Shareholders in the 2000 Annual Report Kenneth Lay stated that, "Enron hardly resembles the company of its early days" [Enron, *2000 Annual Report*].

Enron reported a fantastic growth in revenue, profit, assets, cash from operations, and its stock price in the 1990s, especially the last half of that decade. Its revenue grew from $13 billion in 1995 to $101 billion in 2000, and its net income increased from $495 million in 1995 to $979 million in 2000. Its total assets increased from $16 billion in 1995 to $65.5 billion in 2000. Its cash from operations grew from $742 million in 1995 to $3 billion in 2000. The market price of its stock rose from $15 per share in 1995 to a peak of $90 in 2000. Exhibit 1 shows Enron's financial highlights for the five years 1996-2000 [Enron, *2000 Annual Report*].

ENRON'S SUDDEN COLLAPSE

At the end of the second quarter of 2001, Enron's management continued to give its shareholders, employees, and the public at large an upbeat picture of its future. On July 12, 2001 the company announced a 32 percent increase in earnings per share to $.45 for the second quarter of 2001 from $.34 a year before; a 40 percent increase in net income, from $289 million in the second quarter of 2000 to $404 million in 2001. Jeff Skilling, the CEO at that time, stated that, "Enron completed another quarter of exceptional performance." The company continued to fuel the expectations of investors for a rosy future. Enron announced on that date that it was expecting to achieve $1.80 per share for the full year 2001, an increase of 61% over the $1.12 per share reported in 2000, and $2.15 per share for 2002, a 92% increase over 2000 [Enron News Release, 7/12/2001].

In July 2001, Andrew Fastow, the CFO of Enron, resigned. A month later, in August 2001, Jeffrey K. Skilling, Enron's President and CEO, resigned, citing personal reasons. "I am resigning for personal reasons. I want to thank Ken Lay for his understanding of this purely personal decision, and I want to thank the board and all of my colleagues at Enron." Kenneth L. Lay assumed the responsibilities of President and CEO, and agreed to extend his employment agreement with the company through the end of 2005 [Enron News Release, 8/14/2001].

In August 2001 Mr. Lay received a letter from an anonymous employee who later identified herself as Sherron Watkins, an Enron Global Finance executive (VP for corporate development), alerting him to the possibilities that Enron's fantastic earnings and performance in recent years may be attributed, at least partially, to unrealized profits or hedged losses arising from transactions and hedges with related special purpose entities created by Enron and managed by Andrew Fastow, the past CFO and Mr. Kopper, one of his assistants.

"...it will look like we recognized funds flow of $800 mm from merchant asset sales in 1999 by selling to a vehicle (Condor) that was capitalized with a promise of Enron stock in later years. Is that really funds flow or is it cash from equity issuance? ...We have recognized over $550 million of fair value gain on stocks via our swap with Raptor, much of that stock has declined significantly—Avici by 98%, from $178 mm to $5 mm; the New Power Co. by 70%, from $20/share to $6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is LJM entity...we booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderful high stock price, many executives sold stock, we then try and reverse or fix the deals in 2001 and it's a bit like robbing the bank in one year and trying to pay it back 2 years later. Nice try, but investors were hurt, they bought at $70 and $80/share looking for $120/share and now they're at 38 or worse...a lot of accountants including AA&Co. have blessed the accounting treatment...the footnotes don't adequately explain the transactions...I also don't believe any other company would have entered into the equity derivative transactions with us at the same prices." [Memo to Mr. Lay from Sherron Smith Watkins dated August 21, 2001]

In the fall of 2001 Enron asked Vinson & Elkins LLP, its outside legal counsel, to investigate the claims made by Sherron Watkins to determine whether the anonymous letter and supplemental materials raised new factual information that would warrant a broader investigation. Vinson & Elkins concluded that the facts disclosed through their investigation did not, in their judgment, warrant a further widespread investigation by independent counsel and auditors and that some response should be provided to Ms. Watkins to assure her that her concerns were thoroughly reviewed, analyzed, and although found not to raise new or undisclosed information, were given serious consideration. [*Wall Street Journal*, 1/16/02]

On November 8, 2001, Enron restated its prior periods financial statements to reflect $1.2 billion reduction to shareholders' equity, as well as various income statements and balance sheet adjustments required as the result of a determination by Enron and its auditors, based on current information, that certain off-balance sheet entities should have been included in Enron's consolidated financial statements pursuant to generally accepted accounting principles [Enron News Release, 11/8/01]. The restatement involved its financial statements for 1997 through 2000 and the first two quarters of 2001. The restatement included a reduction to reported income of approximately $96 million in 1997, $113 million in 1998, $250 million in 1999, and $132 million in 2000, increases of $17 million for the first quarter of 2001 and $5 million for the second quarter, and a reduction of $17 million for the third quarter of 2001. These changes in net income are the result of the retroactive consolidation of SPEs beginning in November 1997. The consolidation will also increase Enron's debt by approximately $711 million in 1997, $561 million in 1998, $685 million in 1999, and $628 million in 2000. Exhibits 2-5 show the effect of the November 8, 2001 restatement on Enron's earnings, assets, debt, and equity for the periods affected.

Following Enron' restatement, there was a significant decrease in its common share price. The market price of Enron stock decreased from $49.10 on the last day of the second quarter of 2001 to $8.41 on November 8, 2001, and continued to go down. On March 27, 2002 it declined to $0.20. In addition, Enron's long-term debt rating was decreased to the lowest level of investment grade, with a warning that further downgrades were possible [Emshwiller *et al.*, 2001]. This situation resulted in a loss of investor confidence and significantly affected Enron's ability to raise capital and led to a substantial increase in the level of cash required for collateral and margin deposits for its trading activities.

On December 2, 2001, Enron filed voluntary petitions for Chapter 11 reorganization with the US Bankruptcy Court for the Southern District of New York. Filing for

Chapter 11 reorganization included a total of 14 of its affiliate entities [Enron News Release, 12/2/01]. On December 3, Enron announced it had laid off 4000 employees in its Houston office. On January 17, 2002, Enron's board discharged Arthur Andersen as its auditor, citing the destruction of documents by Andersen personnel and the disciplinary actions taken against several of Andersen's partners working in its Houston office as the reason for its decision [Enron News Release, 1/17/02]. On January 23, 2002, Enron announced that Kenneth L. Lay resigned as Chairman of the Board and Chief Executive Officer of Enron Corp. and as an Enron employee, but would remain on the company's Board of Directors. On February 2, 2002, Enron announced that the Special Investigative Committee of the Board of Directors that was established on October 28, 2001 had completed its investigation and review of transactions between Enron and certain related parties and was making the report available. On February 4, 2002 Enron announced that Kenneth L. Lay had resigned from the Board of Directors, effective immediately. On February 14, 2002, Enron announced it had terminated Richard A. Causey, formerly executive vice president and chief accounting officer, and Richard B. Buy, formerly executive vice president and chief risk officer, effective immediately. On February 20, 2002, Enron announced that James V. Derrick, Jr., executive vice president and general counsel, would retire from Enron, effective March 1, 2002.

In your judgment, was the collapse of Enron a result of : (1) deficiency in financial reporting standards; (2) illegal, or unethical behavior of management; (3) auditing failure; (4) financial analysts conflict of interest; (5) lack of government regulations? What lessons can be learned from Enron's failure?

EXHIBIT 1

ENRON FINANCIAL HIGHLIGHTS, 1996-2000 (In Millions except for EPS)

	2000	1999	1998	1997	1996
Revenues	$100,789	$40,112	$31,260	$20,273	13,289
Net Income	979	893	703	105	584
Cash Flow From Operations	3,010	2,228	1,873	276	742
Interest Charges	838	856	550	401	274
EPS	1.12	1.10	1.01	.16	1.08
Current Assets	30,381	7,255	5,933	4,113	3,979
Current Liabilities	28,406	6,759	6,107	3,856	3,708
Total Assets	65,503	33,381	29,350	25,552	16,197
LTD	8,550	7,151	7,357	6,254	3,349
Shareholders Equity	11,470	9,570	7,048	5,618	3,723
Stock Price: High	909/16	447/8	393/8	229/16	233/4
Stock Price: Low	413/8	283/4	191/16	171/2	175/16
Stock Price Close, Dec. 31	831/8	443/8	2817/32	2025/32	219/16
Profit to Sales	.0097	.0222	.0225	.0052	.0439
Rate of Return on Assets	.0149	.0268	.0240	.0041	.0361
Rate of Return on Equity	.0853	.0933	.0997	.0187	.1569
Current Ratio	1.07	1.07	.97	1.07	1.07
LT Debt to Equity	.75	.75	1.04	1.11	1.11
LT Debt to Assets	.13	.21	.25	.24	.21
Income/Interest (Coverage)	1.17	1.04	1.28	.26	2.31
Total Debt/Assets	.56	.42	.45	.40	.44

Source: *Enron 2000 Annual Report*

EXHIBIT 2

EFFECT OF THE NOVEMBER 2001 RESTATEMENT ON NET INCOME
(In millions of dollars)

	1997	1998	1999	2000	1st Qtr 2001	2nd Qtr 2001	3rd Qtr 2001
Net income as reported	$ 105	$ 703	$ 893	$ 979	$ 425	$ 404	$ (618)
Restatements:							
Consolidation of JEDI and Chewco	(45)	(107)	(153)	(91)	--	--	--
Consolidation of LJM1 subsidiary	--	--	(95)	(8)	--	--	--
Raptor equity adjustment	--	--	--	--	--	--	--
Prior year proposed audit adjustments and reclassifications	(51)	(6)	(2)	(33)	17	5	(17)
NET INCOME RESTATED	**9**	**590**	**643**	**847**	**442**	**409**	**(635)**
% (decrease) increase in income as a result of restatement	(91%)	(16%)	(18%)	(14%)	4%	2%	(3%)

EXHIBIT 3

EFFECT OF THE NOVEMBER 2001 RESTATEMENT ON ASSETS
(In millions of dollars)

	1997	1998	1999	2000	1st Qtr 2001	2nd Qtr 2001	3rd Qtr 2001
Total assets as reported	22,552	29,350	33,381	65,503	67,260	63,392	
Restatements:							
Consolidation of JEDI and Chewco	447	160	187	(192)	--	--	
Consolidation of LJM1 subsidiary	--	--	(222)	--	--	--	
Raptor equity adjustment	--	--	--	(172)	(1,000)	(1,000)	
Prior year proposed audit adjustments and reclassifications	(79)	(87)	(147)	(364)	(1,249)	247	
TOTAL ASSETS RESTATED	**22,920**	**29,423**	**33,199**	**64,775**	**65,011**	**62,639**	**61,177**
% (decrease)increase in asset as a result of restatement	2%	2%	(1%)	(1%)	(3%)	(1%)	--

EXHIBIT 4

EFFECT OF THE NOVEMBER 2001 RESTATEMENT ON DEBT
(In millions of dollars)

	1997	1998	1999	2000	1st Qtr 2001	2nd Qtr 2001	3rd Qtr 2001
Debt as reported	6,254	7,357	8,152	10,229	11,922	12,812	
Restatements:							
Consolidation of JEDI and Chewco	711	561	685	628	--	--	
Consolidation of LJM1 Subsidiary	--	--	--	--	--	--	
Raptor equity adjustment	--	--	--	--	--	--	
Prior year proposed audit Adjustments/ reclassifications	--	--	--	--	--	--	
DEBT RESTATED	**6,965**	**7,918**	**8,837**	**10,857**	**11,922**	**12,812**	**12,978**
% (decrease)increase in debt as a result of restatement	11%	8%	8%	6%	--	--	--

EXHIBIT 5

EFFECT OF THE NOVEMBER 2001 RESTATEMENT ON EQUITY
(In millions of dollars)

	1997	1998	1999	2000	1st Qtr 2001	2nd Qtr 2001	3rd Qtr 2001
Equity as reported	5,618	7,048	9,570	11,470	11,727	11,740	
Restatements:							
Consolidation of JEDI and Chewco	(262)	(391)	(540)	(810)	--	--	
Consolidation of LJM1 subsidiary	--	--	(166)	60	60	60	
Raptor equity adjustment	--	--	--	(172)	(1,000)	(1,000)	
Prior year proposed audit adjustments and reclassifications	(51)	(57)	(128)	(242)	(286)	11	
EQUITY RESTATED	**5,305**	**6,600**	**8,736**	**10,306**	**10,501**	**10,811**	**9,491**
% (decrease)increase in equity as a result of restatement	(6%)	(6%)	(9%)	(10%)	(100%)	(8%)	--

EXHIBIT 6

RELATED PARTY TRANSACTIONS

In 2000 and 1999, Enron entered into transactions with limited partnerships (the Related Party) whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron. Management believes that the terms of the transactions with the Related Party were reasonable compared to those which could have been negotiated with unrelated third parties.

In 2000, Enron entered into transactions with the Related Party to hedge certain merchant investments and other assets. As part of the transactions, Enron (I) contributed to newly-formed entities (the Entities) assets valued at approximately $1.2 billion, including $150 million in Enron notes payable, 3.7 million restricted shares of outstanding Enron common stock and the right to receive up to 18.0 million shares of outstanding Enron common stock in March 2003 (subject to certain conditions) and (ii) transferred to the Entities assets valued at approximately $309 million, including a $50 million note payable and an investment in an entity that indirectly holds warrants convertible into common stock of an Enron equity method investee. In return, Enron received economic interests in the Entities, $309 million in notes receivable, of which $259 million is recorded at Enron's carryover basis of zero, and a special distribution from the Entities in the form of $1.2 billion in notes receivable, subject to changes in the principal for amounts payable by Enron in connection with the execution of additional derivative instruments. Cash in these Entities of $172.6 million is invested in Enron demand notes. In addition, Enron paid $123 million to purchase share-settled options from the Entities on 21.7 million shares of Enron common stock. The Entities paid Enron $10.7 million to terminate the share-settled options on 14.6 million shares of Enron common stock outstanding. In late 2000, Enron entered into share-settled collar arrangements with the Entities on 15.4 million shares of Enron common stock. Such arrangements will be accounted for as equity transactions when settled.

In 2000, Enron entered into derivative transactions with the entities with a combined notional amount of approximately $2.1 billion to hedge certain merchant investments and other assets. Enron's notes receivable balance was reduced by $36 million as a result of premiums owed on derivative transactions. Enron recognized revenues of approximately $500 million related to the subsequent change in the market value of these derivatives, which offset market value changes of certain merchant investment and price risk management activities. In addition, Enron recognized $44.5 million and $14.1 million of interest income and interest expense, respectively, on the notes receivable from and payable to the Entities.

In 1999, Enron entered into a series of transactions involving a third party and the Related Party. The effect of the transactions was (I) Enron and the third party amended certain forward contracts to purchase shares of Enron common stock, resulting in Enron having forward contracts to purchase Enron common shares at the market price on that day, (ii) the Related Party received 6.8 million shares of Enron common stock subject to certain restrictions and (iii) Enron received a note receivable, which was repaid in December 1999, and certain financial instruments hedging an investment held by Enron. Enron recorded the assets received and equity issued at estimated fair value. In connection with the transactions, the Related Party agreed that the senior officer of Enron would have no pecuniary interest in such Enron common shares and would be restricted from voting on matters related to such shares. In 2000, Enron and the Related Party entered into an agreement to terminate certain financial instruments that had been entered into during 1999. In connection with this agreement, Enron received approximately 3.1 million shares of Enron common stock held by the Related Party. A put option, which was originally entered into in the first quarter of 2000 and gave the Related Party the right to sell shares of Enron common stock to Enron at a strike price of $71.31 per share, was terminated under this agreement. In return, Enron paid approximately $26.8 million to the Related Party. In 2000, Enron sold a portion of its dark fiber inventory to the Related Party in exchange for $30 million cash and a $70 million note receivable that was subsequently repaid. Enron recognized gross margin of $67 million on the sale. In 2000, the Related Party acquired, through securitizations, approximately $35 million of merchant investments from Enron. In addition, Enron and the Related Party formed partnerships in which Enron contributed cash and assets and the Related Party contributed $17.5 million in cash. Subsequently, Enron sold a portion of its interest in the partnership through securitizations. See Note 3. Also, Enron contributed a put option to a trust in which the Related Party and Whitewing hold equity and debt interests. At December 31, 2000, the fair value of the put option was a $36 million loss to Enron.

In 1999, the Related Party acquired approximately $371 million of merchant assets and investments and other assets from Enron. Enron recognized pre-tax gains of approximately $16 million related to these transactions. The Related Party also entered into an agreement to acquire Enron's interests in an unconsolidated equity affiliate for approximately $34 million.

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